EQUITY

Keeping One's Options Open: The Case for Global Convertibles

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When the outlook is uncertain, it can be good to keep one's options open. Alan Muschott, vice president and portfolio manager, Franklin Equity Group, says convertible securities' ability to adapt to myriad market conditions makes them an attractive vehicle as we head into the uncertainties of the year ahead. He outlines why companies issue convertible securities—and why many investors find them an attractive addition to their portfolios.

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Bond-Equity Hybrids Let Investors Keep Their Options Open

Convertible securities are a unique asset class in the investment world, offering investors both the growth potential of common stocks and the income offered by bonds. Issued by companies looking to raise capital, these hybrid investments are generally structured as some form of debt (bonds, debentures) or preferred shares with an embedded option that allows conversion into common shares under predetermined conditions.

The debt features of convertibles stem from the interest payments and claim to principal. In this respect, convertibles are similar to bonds, with characteristics that can potentially offer less value erosion in declining markets than the underlying common stock. But they are also similar to stocks because their embedded conversion component allows investors to participate in the stock's price appreciation potential.

If a company's common stock rises, the convertible security should increase in value because of the conversion option. If the common stock does not perform well, the fixed income component may help provide a buffer against greater losses than the common stock alone might experience. Because of these unique characteristics, convertibles may be classified as fixed income securities, equity securities or as a separate asset class.

Convertibles are attractive in low interest-rate environments when sources of income may be scarce. Historically, they have tended to perform well during periods of above-average market volatility, when cautious investors with a generally positive view of the equity markets seek risk-controlled equity exposure to reduce potential downside risk. (See chart below)

Rising stock markets also tend to favour convertibles due to the price relationship with the underlying common stock. We believe this ability to adapt to myriad market conditions makes convertibles an attractive vehicle for increasing a portfolio's diversification.

Convertibles Performance in Varying Market Conditions

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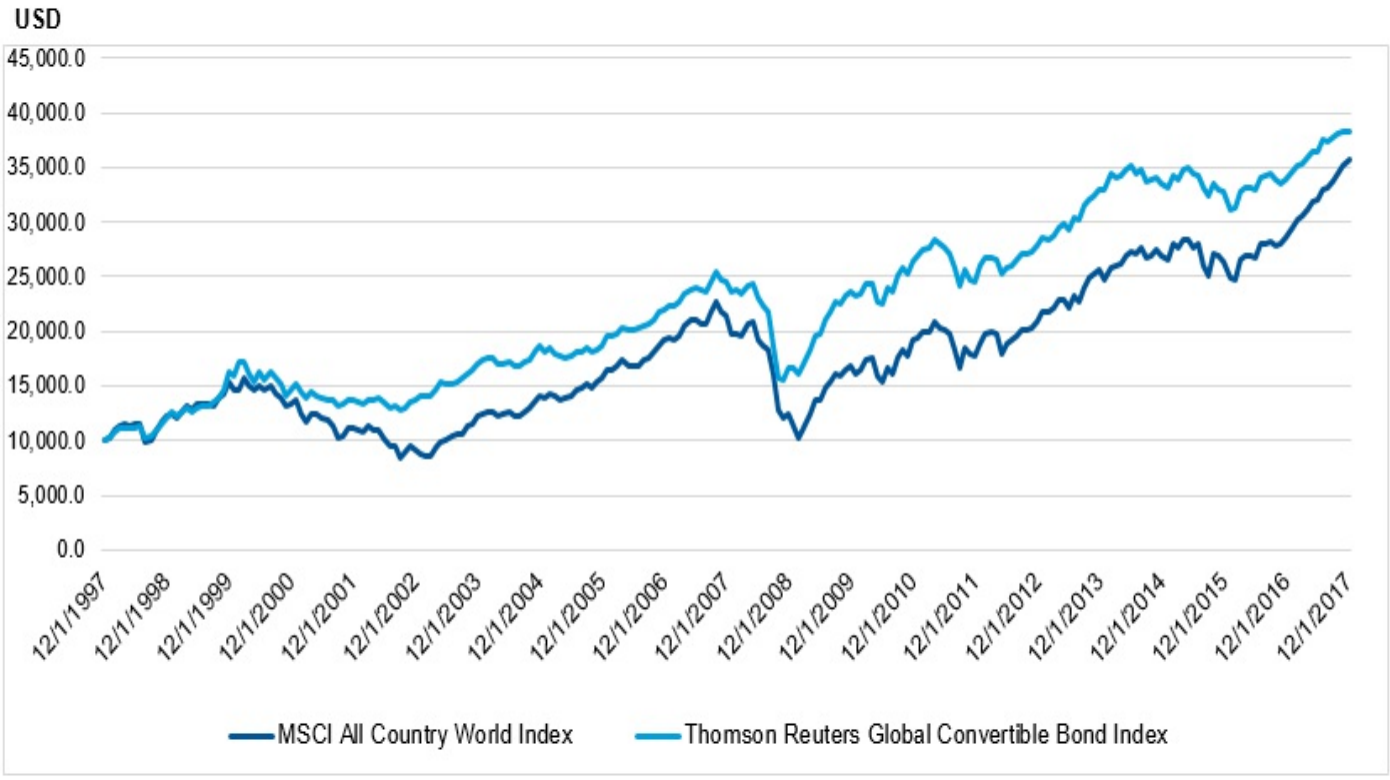
Growth of a US$10,000 Investment
20 Years Ended 31 December, 2017



Source: Morningstar. See www.franklintempletondatasources.com for additional data provider information. The MCSI All Country World Index is a market-capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. the Thompson Reuters Global Convertible Bond Index is designed to provide a broad measure of the performance of the investable, global convertible bond market

Past performance does not guarantee future results. The above is a hypothetical example used solely for illustrative purposes. It does not represent securities of an actual account or portfolio. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges.

Why Companies Issue Convertibles

Convertibles allow companies to finance activities through a lower-cost form of debt that offers less potential dilution to the common shares than selling common stock. While convertibles can come with elevated risks, there are some potential advantages.

Potential advantages to the issuer include:

- Lower interest payments relative to straight debt
- Less potential share dilution compared to equity issuance
- Equity issued at a premium to the current stock price
- Ability to reach a broader range of investors

Within a company’s capital structure, convertibles can be ranked at various levels of seniority ranging from the most junior preferred stock to senior secured debt. Most convertibles are issued as senior unsecured debt, which ranks higher than stocks with respect to income distribution or liquidation.

Four Good Reasons to Consider Investing in Convertibles

1. Current Income. Investors seeking yield from equity securities may find convertibles an appealing option, as they generally provide a more attractive income component than stocks alone (although generally lower than traditional bonds), while still allowing participation in the stock's price movement.

2. Potentially Attractive Risk/Reward Profile. Historically, convertibles typically have exhibited a low correlation to fixed income and demonstrated imperfect correlation with stocks. This creates potential for an investor to help enhance portfolio diversification, dampen volatility and improve a portfolio's overall risk profile. (See chart below.) Note, diversification does not guarantee profit or protect against risk of loss.

3. Attractive Potential for Long-Term Risk-Adjusted Returns. Critics point out that convertibles do not increase as rapidly in value as stocks during rising markets; nor does their potential downside protection equal that of bonds during market declines. Nevertheless, historically they have been able to deliver attractive long-term risk-adjusted returns compared with both stocks and bonds.

4. Robust and Diverse Opportunity Set. The flexible nature of convertibles makes them appealing to a broad range of investors. As a group, convertibles have historically presented an attractive risk/reward profile, but within the group there is considerable variation in the level of risk, sensitivity to movements in the underlying stock and upside participation. Not only are these securities diversified across credit ratings, sectors, market capitalisation and investment characteristics, they are also available worldwide.

ANATOMY OF A CONVERTIBLE

Convertibles possess a distinct structure that includes characteristics that may be unfamiliar to some investors such as the conversion ratio, parity, conversion premium and delta.

Conversion ratio sets out the number of common shares due upon conversion to the underlying stock. The conversion price, which is calculated by dividing the price of the convertible at issue by the conversion ratio, determines the price of the underlying common stock that is required for conversion. Generally, the conversion price is set upon issuance at a premium of anywhere from 15% to 50% relative to the price of the underlying common stock, with 20% to 30% being the most typical range.

Parity refers to the value of the convertible upon conversion. It is calculated by multiplying the conversion ratio by the current stock price.

Conversion premium is the value by which the price of the convertible exceeds its parity and is calculated as a percentage of parity.

Delta measures the sensitivity of the convertible price to changes in the price of the underlying common stock.

Taking It Global

With a value of over US$330 billion as of the third quarter of 2017, the global convertible securities market is a sizeable player in the world's capital markets. The United States accounted for over half that amount, followed by the Europe, Middle East, Africa (EMEA) and Asia-Pacific regions, respectively.[1]

Perhaps more important is the ample room for growth. Following a peak in 2007, issuance declined as companies took advantage of low yields, a high equity risk premium relative to credit spreads and strong flows into the credit markets to issue straight debt rather than convertibles. The perception was that raising capital through straight debt was relatively cheap, even when convertible securities were issued at slightly lower rates due to the added concern of share dilution. Companies were also hesitant to issue convertible securities as equity valuations were inexpensive relative to historical levels.

In 2017, we saw seen slightly stronger issuance figures than in the prior year, driven by better equity market performance, a rise in interest rates and higher spreads.

Potential catalysts for increased issuance include:

- An increase in US interest rates that may lead companies to prefer more cost effective means of raising

capital (such as convertibles) than traditional debt, particularly as equity valuations have been near or at historical highs for many issuers.
- A secular shift in Europe from loan to bond financing and high funding cost for high-yield issuers.
- Refinancing of existing convertibles in the Asia-Pacific region.
- Long-term growth coupled with financing requirements in China reducing risk through portfolio construction.

Some investors may have concerns about the credit profile of a convertible issuer. Active portfolio management, fundamental research and a bottom-up approach to security selection can be used to address these concerns by targeting companies with rising credit profiles.

While default risk is an important factor when evaluating securities, many other elements must be considered before making an investment, such as business fundamentals, asset and cash flow coverage of debt and fixed costs, and the likelihood of improvement in the underlying credit profile.

Convertibles: Broadening the Opportunity Set

Although past historical performance cannot guarantee future results, global convertibles, based on historical characteristics, offer the potential for low correlation to other asset classes, a broad universe of opportunities, and exposure to emerging as well as developed regions, which may help to reduce risk through portfolio diversification.

Correlation of Global Convertibles to Select Asset Classes: 15-Year Period

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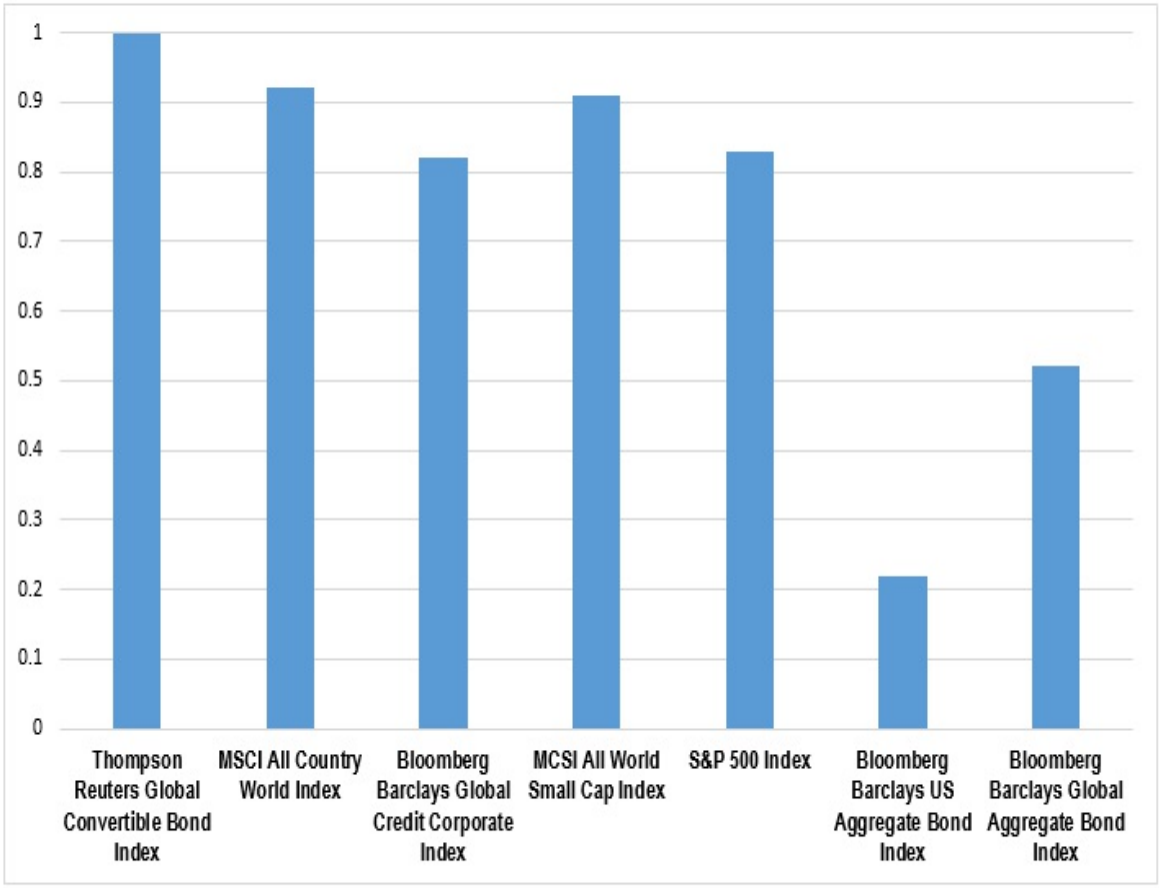
As at 31 December, 2017



Source: Morningstar. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges.

Past performance does not guarantee future results.

Convertible securities can present opportunities for investors to “hedge their bets” by providing characteristics of both the fixed income and equity markets. For those seeking income and risk-managed equity exposure, these investments offer numerous potential benefits, including:

- Current income that is usually higher than a stock’s dividend.
- Upside participation in the underlying common stock’s price with less downside risk.
- Typically less volatility than the underlying common stock alone.
- Additional diversification potential and a means that seeks to improve the risk/reward profile in a portfolio.
- A claim on the issuer’s assets senior to holders of common shares.

Worldwide, convertible securities are garnering increasing attention from both issuers and investors. The asset class has ample room for expansion as companies across the globe look for financing and endeavour to attract investors to their common shares at the lowest possible cost.

We believe higher levels of creditworthiness in the developing markets and fiscally healthy companies in the developed markets point to abundant opportunities for participating in corporate growth, even in uncertain markets—possibly the strongest argument for including a component of global convertible securities in a diversified portfolio of investments.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Generally, those offering potential for higher returns are accompanied by a higher degree of risk. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of a portfolio may decline. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Convertible securities are subject to the risks of stocks when the underlying stock price is high relative to the conversion price (because more of the security's value resides in the conversion feature) and debt securities when the underlying stock price is low relative to the conversion price (because the conversion feature is less valuable). A convertible security is not as sensitive to interest rate changes as a similar non-convertible debt security, and generally has less potential for gain or loss than the underlying stock.

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1. Source: Barclays, as at 30 September, 2017.

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